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Mid-Year Capital Markets Update: Pivot Patience

Capital Market Returns, Economic Resilience, and Persistent Inflation

As we reach the halfway point of 2024, capital markets continue to play the waiting game as the Federal Reserve's patience is tested by resilient inflation statistics. US stocks have shrugged off inflation fears, appreciating 15.3% as of June 30, while international developed and developing markets have seen their values rise 5.3% and 7.5%, respectively. The bond market has continued to be a challenging place to invest, with returns on intermediate bonds slightly positive and long-dated bonds seeing negative returns as of June 30. The US aggregate bond market index has seen its value fall a modest -0.7% as of the end of the second quarter. Alternative strategies have provided stability to diversified portfolios with the HFRI Global Hedge Fund Index rising 2.9% year-to-date. (Source: Chart below, Morningstar, June 30, 2024)

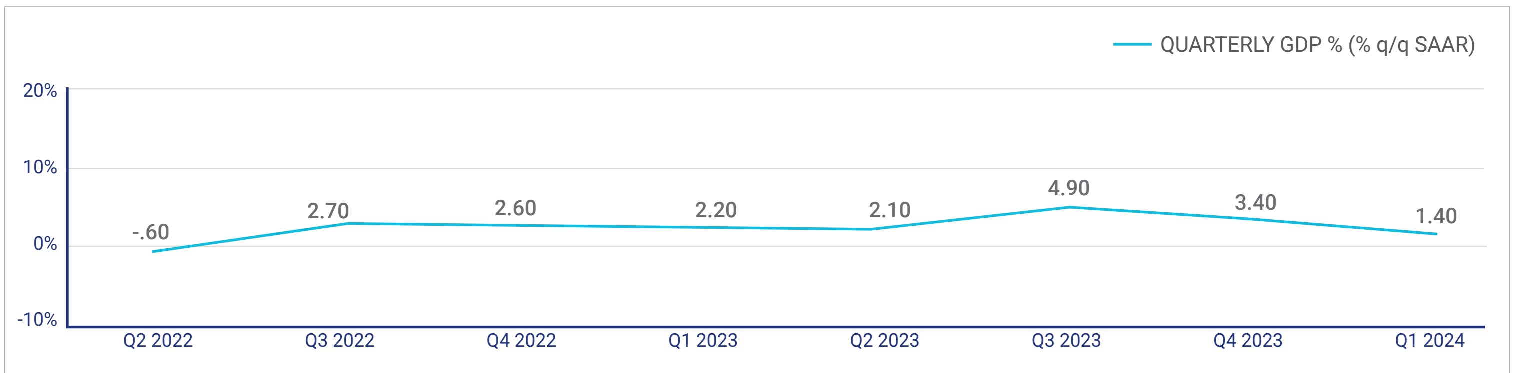
Asset Class Returns

	Asset Class	Index	June 2024	Q2 2024	YTD 2024
Equity	US Large Cap	S&P 500 TR USD	3.6	4.3	15.3
	US Small Cap	Russell 2000 TR USD	-.09	-3.3	1.7
	International Developed	MSCI EAFE NR USD	-1.6	-0.4	5.3
	Emerging Markets	MSCI EM NR USD	3.9	5.0	7.5
Fixed Income	US Investment Grade	Barclays US Aggregate TR USD	0.9	0.1	-0.7
	US Inflation-Indexed	Barclays US Treasury US TIPS TR USD	0.8	0.8	0.7
	US High Yield	Barclays US Corporate High Yield TR USD	0.9	1.1	2.6
	EM US$ Debt	JPM EMBI Global Diversified TR USD	0.6	0.3	2.3
Alternative	Absolute Return	HFRX Global Hedge Fund USD	0.3	0.4	2.9

Source: Morningstar
All citations from Morningstar as of 06/30/2024

US economic growth continues to drive strong results for equity markets, despite persistent levels of inflation. Earlier predictions of a recession have not materialized, as real GDP growth has slowed but remained well in positive territory. (see chart below).

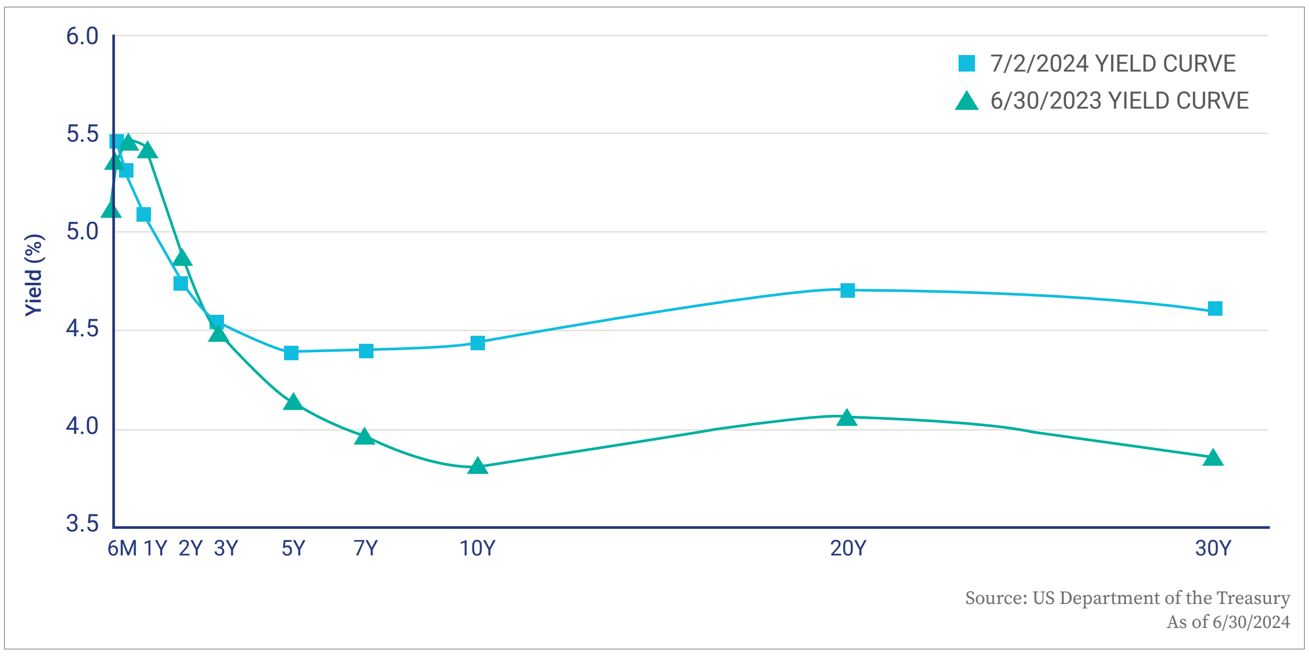
U.S. Real GDP Growth



Source: FactSet
As of 6/30/2024

However, this stable growth comes at a cost – inflation remains stubbornly elevated. As a result, the Federal Reserve has been thwarted in its battle against inflation, forced to maintain higher levels of interest rates than it prefers. As a result, fixed income investing has been more of a challenge due to a volatile interest rate environment. As the two charts below show, the 10-year US Treasury bond's rate has been as low as 3.3% (April 2023) and as high as 5.0% in October 2023, while the short end of the treasury curve remains above 5%. Volatility in the longer end of the yield curve causes us to remain focused on shorter-dated maturities.

U.S. Treasury Yield Curve



Interest Rate Swings

10-year U.S. Treasury Yield since 10/24/2022

The Long-Term Impact of AI

Artificial intelligence, or "AI," continues to dominate the news as well as the financial markets. Any mention of AI being incorporated into a company's business processes these days typically results in a rapid boost to the share price. AI proposes to help businesses produce more goods and services without requiring a commensurate increase in costs. AI has the potential to significantly enhance long-term economic productivity by automating tasks, improving efficiency, and driving innovation. While the near-term impact of AI may be uncertain, its long-term potential for economic benefit is staggering. Estimates say that AI could contribute as much as $15 trillion to the global economy by 2030. (Source: BofA.com "Artificial intelligence: A real game changer- Bank of America")

Unsurprisingly, most of today's market leaders are heavily involved in AI, as both suppliers and consumers. While NVIDA, Microsoft, and META (for example) are seemingly obvious AI beneficiaries, we think the coming years will be characterized by a broadening out of AI winners. Sectors such as Utilities (a Chat GPT search that uses 10x the electricity of a Google Search); Health Care (Diagnostics and Drug Development/Research); and Finance (Bank Security, Customer Service). (Source: www.goldmansachs.com "AI is poised to drive 160% increase in data center power demand- Goldmansachs")

As we have said in previous editions of "Market Insights," we often think about equity investing in terms of themes rather than in traditional growth/value buckets. This is a great example of that, as AI has a chance to touch nearly every sector of the market over the coming years and decades.

Election Year Jitters

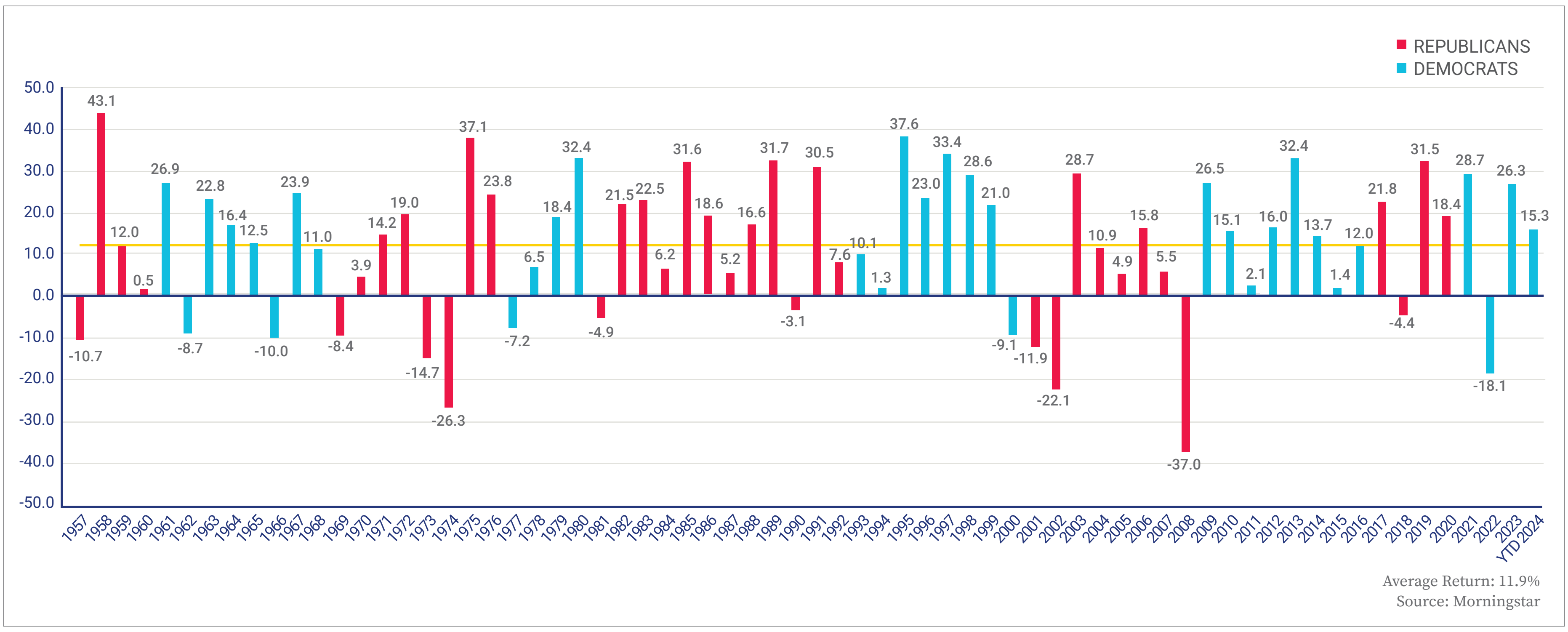
As if persistent inflation, concerns over economic growth, and ongoing global conflict weren't enough to keep investors awake at night, we have a presidential election to deal with this fall. Historically, presidential election years have presented a mixed bag for investors. While some years have produced strong market performance, others witnessed increased volatility. Since 1950, however, US stocks have risen an average of 9.1% in election years. (Source: [Fidelity.com "What does the election mean for the stock market? | Fidelity"])

Given the current divisive political climate, the upcoming election adds another layer of uncertainty to the investing environment. While financial markets have done well in both Republican and Democratic administrations, we may feel a greater than usual impact based on the victorious party. Under a Trump presidency, fiscal policy would likely include an attempt to make permanent the tax cuts from the 2017 Tax Cuts and Jobs Act, which would be partially paid for with spending cuts. Under a second Biden term, some of the tax cuts from the 2017 Tax Cuts and Jobs Act could be extended while other provisions would likely be allowed to sunset at the end of 2025. (Source: [Assessing the market impact of the 2024 presidential election | J.P. Morgan Asset Management (jpmorgan.com)])

Regardless of who wins in November, clients should keep in mind that since 1957 the S&P 500 has averaged an approximate 10% annual return, and the US economy has continued to expand at a healthy pace.

S&P 500 Annual Returns (%)

1957 through June 30, 2024



During those periods, both Republicans and Democrats have served in the Oval Office. We caution all investors to not allow political views to dictate how they invest their portfolios; doing so could derail one's plan to reach long-term financial goals. (The 2024 presidential election and the stock market | Invesco US)

Our Asset Allocation Viewpoints

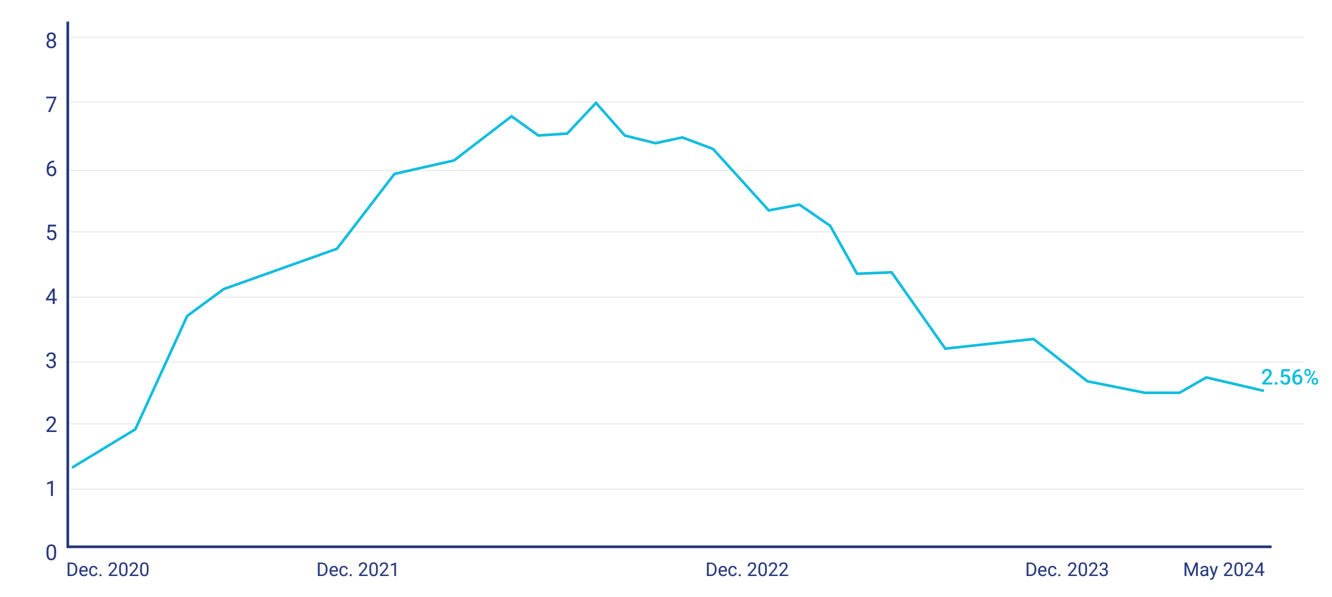
We continue to favor US equities relative to international markets, despite the concentration of the S&P 500 in a select number of technology-oriented companies. We have favored US equities over international for quite a few years now, and that positioning has been additive to client returns. While this concentration does pose some risk, we believe the long-term growth potential of US companies remains attractive relative to the rest of the world. The US economy and (not coincidentally) the earnings of US companies have outperformed most of the world by a healthy margin. That said, we are global investors and we recognize that the US likely won't have the lead forever. The ECB moved to cut rates before the Fed, delivering a 25 basis point cut on June 6. Will that be the catalyst European stocks have needed? Time will tell, but for now we will continue to monitor the situation while retaining our US overweight.

Bonds and Duration

Given the persistence of inflation, we remain underweight bonds and duration in client accounts. We continue to believe interest rates are likely to stay higher for longer than some anticipate. When 2024 began, market consensus was that the Fed would lower interest rates five to six times during the year and that investors should pile into longer duration bonds. We resisted that urge and disagreed with the consensus view. To us, a strong labor market and "sticky" inflation across several services categories made "higher for longer" the more likely scenario. However, we recognize that rates will eventually trend downward as inflation subsides and inflation approaches the Fed's target rate of 2%. We will be strategically adding back to bonds and lengthening duration as the economic picture evolves but have no plans to do so imminently. For now, clipping short-dated coupons above 5% feels like a more prudent move than chasing price return in longer bonds.

Inflation

Headline PCE Inflation | December 31, 2020 through May 31, 2024



Source: FactSet
As of 6/30/2024

The Importance of Alternatives

In today's environment, where correlations between traditional stocks and bonds have increased, we believe alternative investment strategies are more important than ever. In fact, as of March 31, the correlation between the S&P 500 and the Bloomberg Barclay's Aggregate Fixed Income index was 0.69, the highest on record going back to 1926. (Source: Blackrock "Student of the Market," June 2024 edition.) Alternatives are now, more than ever, providing that true diversification from equities that we used to turn to bonds for. In today's environment, alternatives are showing less correlation to stocks and bonds than in past decades and are also benefiting from higher interest rates because many of these strategies have an income component. We are overweight alternatives in client portfolios to take advantage of the attractive current opportunity and to help navigate the current market volatility.

The chart below clearly illustrates how alternative strategies, as represented by the HFRI Global Hedge Fund Index, have helped to reduce the volatility that we have experienced in both stock and bond markets over the past three years. With our underweight position in bonds and overweight position in alternative strategies, our portfolios have enjoyed strong performance relative to our benchmarks. As the Fed continues to wrestle with sticky inflation and an inverted yield curve, we are likely to continue to rely on these investments moving forward.

3 Year Monthly Performance as of 06/30/2024

Source: Morningstar

Thank You

We appreciate your continued partnership and trust in Webster Private Bank. Should you have any questions or concerns, please do not hesitate to reach out to your trusted relationship manager. Together, we will navigate the current market environment and seek to achieve your long-term financial goals.